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June 2, 1997

Michael Mazerov
Multistate Tax Commission
Suite 425
444 North Capitol Street, NW
Washington, DC 20001

Re: Business Income Issues

Dear Michael:

This letter is in response to the fax that I received from you on May 19, 1997, relating to the business/nonbusiness income issue.

I had written to Dan about the proposed regulations in 1995 and a copy of that letter is enclosed. Let me now address some of the points raised in the staff memorandum of November 20, 1996 ("Memorandum").

Let me begin by stating that in my view the functional test is a correct approach to the problem from the standpoint of tax policy. If an asset produces business income for a corporation, gain or loss on its sale should be treated as business income items. My problem with the MTC's approach has been that I don't think that the statutory language gets you there. Although I recognize that getting state legislatures to change their statutes is harder than getting state tax administrators to change their regulations, my recommendation would be that the statutory language be changed and that our working group focus on statutory as well as regulatory issues in this area.

The Memorandum asks whether multistate businesses would benefit from the development of a uniform rule on the classification of apportionable income. I strongly believe that they would benefit from a uniform rule and, further, that they know this.

Although a tax manager at a corporation obviously is going to use the existing rules, including any lack of uniformity, to his or her company's advantage, my conversations with tax managers indicate that there is a strong consensus in favor of uniform rules. This would simplify tax planning and certainty of result. The issue that worries tax managers more than any other is their inability to predict the tax consequences of corporate transactions. Neither they nor (more importantly) their bosses like to be surprised. Any movement in the direction of greater uniformity would reduce the uncertainty in tax planning and, hence, the psychiatric expenses of those of us who do it. Although in some cases corporations may be unhappy about giving up certain tax planning options, I have no doubt that the great majority of corporate tax managers would favor an increase in uniformity among the states.

The Memorandum asks whether multistate business has a stake in preserving the line of cases that have rejected the functional test. This in my view is purely a matter of the tax liability of particular companies in particular cases. As a general proposition it is probably true that companies would normally prefer to allocate a particular item of income rather than to apportion it, but this is not always the case and some of the litigated cases involve arguments by taxpayers that gain from the sale of assets should be apportionable business income. Although in most cases companies will benefit from a narrower definition of business income, I don't think that they will go to the mat on this issue.

This leads to my next point, which addresses the inquiry in the Memorandum as to how multistate businesses and tax administrators can conduct a meaningful dialogue with respect to the classification issue. In particular, the Memorandum asks why states should "forego recognition of the functional test." The problem is with the statute. In my view and in that of many private practitioners, the statutory language does not justify the interpretation that is reflected in the functional test. Even if tax administrators disagree with that view, they must recognize that it is not an unreasonable one. If a statute is ambiguous, there is no reason why anyone, either a corporation or a state tax department, should not adopt an interpretation that is to its advantage. The mere fact that a state tax department adopts a regulation incorporating its interpretation of the statute does not mean that a corporation is required to follow that regulation if it believes that the regulation's interpretation of the statute is incorrect. Although courts often defer to administrative regulations, they are not required to do so and have felt free to overturn them if they felt that they were improper interpretations of the statute, as many of the court cases in this area indicate.

In short, I believe that the only way to resolve the dispute is to amend the statute. While it is helpful for tax administrators and business representatives to talk to each other about these issues, the problem is not going to be resolved as long as the statute remains ambiguous and people can in good faith adopt either interpretation. As long as that is the case, people on both sides of the line will have an obligation to their organizations to adopt an interpretation that is most favorable to their organizations and, in consequence, the litigation will continue. Although the Memorandum refers to the cases rejecting the functional test as a "limited line of cases," that may be wishful thinking on the part of the MTC, witness the recent Uniroyal case in Alabama.

The Memorandum asks at II.C.6.a. whether a state tax administrator has the authority to adopt regulations interpreting constitutional limits on state taxation. I see no reason why a tax department should not adopt such regulations. The Constitution, after all, imposes limits on the ability of states to levy taxes. While a court may not feel itself bound to follow, or give special deference to, a tax administrator's interpretation of the Constitution, there is no reason why taxpayers and tax auditors should not have the benefit of knowing the tax department's views on the constitutional limits.

I take exception to the example at the middle of page 6 of the Memorandum. Why should there be a presumption that funds placed in a segregated interest-bearing account pending a decision by management as to how they should be used produce business income? I would think that the presumption would be the other way. If funds are invested in passive investments, the presumption should be that the resulting income is investment income unless it can be shown that the fund was being held for the specific purpose of being dedicated to active business operations. In fact, even if management has made a decision to invest the funds in the business, the point is that until that investment is made they are producing passive investment income. I might make an exception for short-term (e.g., a week or two) funds that are awaiting immediate use, but in the example in the regulation the funds are held in a passive mode for six months. In any event, the example does not indicate the source of the funds. Would it make a difference in the MTC's thinking if the funds had been generated by the sale of assets that were clearly nonbusiness assets the gain on which was nonbusiness income? I am not sure why it should, but that is an issue that we might discuss.

Proposed regulation IV.1.a.(3)(B), quoted on page 7 of the Memorandum, indicates that a transaction should produce business income under the transactional test "if it is reasonable to conclude transactions of that type are customary in the kind of trade or business

being conducted or are within the scope of what that kind of trade or business does." I disagree with this provision. It seems to me that the purpose of the transactional test is to focus on whether the sale is a normal incident of the business of the particular taxpayer making the sale and not of some other hypothetical taxpayers who might be engaged in the same business but who conduct it in a different way. As an illustration of the point, assume that the taxpayer is an automobile dealer and uses some automobiles as demonstrators and does not hold them out for sale. At the end of the model year, the dealer, being a public spirited sort, always gives the demonstrators to charity. In a particular year, it decides to sell one of the demonstrators, giving the rest to charity. It seems to me that such a sale would not be in the ordinary course of that particular dealer's business and should not result in business income under the transactional test, even though most other automobile dealers regularly sell their demonstrators at the end of the model year. The focus should be on whether the sale is a regular incident of the particular taxpayer's business. If sales of such property are regularly made by people in similar businesses, that would be a factor to be considered by a tax department auditor, but it should not be a decisive principle of construction in an interpretative regulation. It would be more appropriate for such a principle to be placed in a tax department's internal audit guidelines, but, even there, it should be included as a method of analysis and not as an interpretative rule.

The Memorandum on pages 7-8 raises the question of depreciation and whether depreciation that produces a deduction from business income in one year should give rise to nonbusiness gain in a later year. This is an argument that is often made, and it was made in the debate in which I participated at the MTC meeting in Portland, Maine, last year. Let me respond in several ways. First, the thrust of the argument is a policy one, not one of statutory interpretation. As indicated at the beginning of this letter, I agree fully with the MTC's position with respect to the tax policy validity of the approach reflected in the functional test; my problem is not with the policy but with whether the statute provides a basis for it. The depreciation argument does not address the statutory language point. Second, the premise of the depreciation argument is that gain on a sale of depreciable property represents in part a recovery of the depreciation deductions (i.e., that it is an indication that the depreciation deductions should not have been claimed because the value of the property did not go down by a corresponding amount). This may or may not be true as an economic matter in particular cases. For example, depreciation deductions taken with respect to a building may accurately reflect the economic effect of physical deterioration. If the building is sold at a substantial gain because of a general increase in the value of real estate in the community, that gain would not represent a recovery of depreciation deductions or be evidence that the depreciation

deductions exceeded the loss of value resulting from physical deterioration of the building. The same can be true with respect to tangible personal property. See, generally, the discussion of the Supreme Court in Fribourg Navigation Company, Inc. v. Commissioner, 383 U.S. 272 (1966).

The Memorandum on page 8 describes the functional test as being "awfully close" to the "constitutional test the U.S. Supreme Court recognized in Allied Signal for determining apportionable income." I am not sure what "awfully close" means, but, in any event, the Supreme Court in Allied Signal merely held, as it had said in ASARCO and Woolworth, that a state may treat income from a unitary business as apportionable business income. It did not say that a state had to so treat such income. The point is not whether the functional test is constitutional (I think that it is). If there is a consensus that it represents sound tax policy, the inquiry should be on methods for incorporating it into the law and for reducing disputes between taxpayers and tax administrators in this area.

Best regards.

Sincerely,

Peter L. Faber

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June 20, 1995

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Re: Proposed Amendment to Regulations
Regarding Classification of Income
as Business or Nonbusiness

Dear Dan:

I have the following comments with respect to the April 1995 proposal. I realize that some of these comments apply to the current regulations, as well as to the proposed amendments, but I thought that it would be most useful if the comments could be addressed to the regulations, as amended, including old provisions as well as new ones.

I start the discussion with a fundamental disagreement with a premise of the regulations, which I will express briefly and not dwell on. Although the functional task makes eminent good sense as a matter of tax policy, I do not find any support for it in the statutory language. As several courts have pointed out, the word preceding "disposition" in UDITPA is "and," not "or." Although other courts have concluded that the statute does justify applying the functional test as an alternative to the transactional test, in my view they have found that test somewhere in the ether and not in the statutory language. These views are expressed in more detail in an article of mine in the current issue of The Tax Executive, a copy which is enclosed.

In the remainder of this letter, I will assume that the functional test is appropriate and will comment on the specifics of the proposed regulations.

Section IV.1.(a).(2)(B) provides that a taxpayer's income is business income "unless clearly classifiable" as nonbusiness income. This is inconsistent with the structure of the regulations because the regulations define business income at great length and say that nonbusiness income is all income that is not business income.

In any event, I see no reason why there should be a tilt in favor of business income classification. Corporations these days have nonbusiness income as well as business income, and I see no reason why the regulations should place a special burden on a taxpayer trying to establish that income should be treated as nonbusiness income. Moreover, the tilt in the regulation is one-sided. A tax administrator who wants to treat income as nonbusiness income has no special burden of persuasion to meet. Only a taxpayer seeking a similar determination has a special obstacle to overcome. Keep in mind that under general administrative law principles, reflected in the statutes and regulations of most states, a decision of a tax administrator on any issue is presumptively correct. That being the case, why should a taxpayer's normal burden of persuasion be any tougher with respect to this issue?

The statement of the transactional test in Section IV.1.(a).(3) refers to income "arising from transactions and activity...." I have never understood what the words "and activity" refer to. If they have a particular meaning, that meaning should be spelled out. Other superfluous language appears in Section IV.1.(a).(3)(B). I would suggest deleting the phrase "it is reasonable to conclude" and the phrase at the end of the section "or are within the scope of what that kind of trade or business does." This language adds nothing to the regulation.

More importantly, I would suggest that the statement of the transactional test provide more detail about the test's operation under different circumstances, addressing some of the issues that have come up in the court cases.

For example, the regulations might provide that it is not necessary that the income be generated from the taxpayer's primary income-producing activity or that the asset that is sold be held primarily for that purpose. An example would be the sale of a demonstrator car by a car dealer after it has been used for six months. Although the car would not ordinarily be classified as inventory, its sale is a regular incident of the business and the resulting income should be business income under the transactional test. (While I realize that such a sale would also produce business income under the functional test, the

regulations should assume that reliance cannot be placed on the functional test to reach the right result because some states have concluded, and will conclude in the future, that the functional test is not supported by the statutory language and that the sole test is the transactional test.)

Other factors that some courts have found relevant in applying the transactional test are the frequency of sales, the size of the transaction, whether the transaction was prompted by unusual circumstances, and whether the sale proceeds are reinvested in the business. The regulations might indicate the extent to which these factors are relevant in applying the transactional test.

The words "integral, functional, necessary, or operative" occur several times in the provisions dealing with the functional test. I am not sure what any of these words mean. If the property is "used" in the taxpayer's business, isn't that enough? Why does it have to be "integral" to the business, and what do the words "functional" and "operative" mean in this or any other context? I realize that these words appear occasionally in court cases, but the MTC should not use the English language loosely just because some judges do.

Section IV.1.(a)(4)(B) indicates that if property was ever used in the taxpayer's business its sale must forever produce business income. This concept was rejected in Laurel Pipe Line Company v. Commonwealth of Pennsylvania, 537 Pa. 205, 642 A. 2d 472 (1994)(sale of pipeline that had been idle for three years produced nonbusiness income). Regardless of whether one agrees with the result on the facts of that particular case, clearly there must be a point at which property becomes nonbusiness property. What if a corporation stopped using property in its business, discontinued the business, began to hold the property as an investment, and sold it thirty years later? Surely any resulting gain should be treated as nonbusiness income. While I would not oppose a rule that said that property sold within a reasonable liquidation period after the winding up of the business (or of its use in a business) should produce business income, property that was clearly and affirmatively converted to an investment function from a business function should produce investment income if later sold. You might provide for a presumption if the sale occurred within or beyond a specified period from its withdrawal from the business. While a theoretical argument can be made that gain attributable to an increase in value while property was used in a business should be treated as business income even if the property is later sold years after its conversion to investment use, requiring an appraisal of property when it is converted from

business to nonbusiness use or from nonbusiness to business use would be administratively burdensome and impractical. Since property can be converted either way, I would favor abandoning any search for theoretical purity and providing that the property's use at the time of sale determines the characterization of all gain realized on that sale.

The same paragraph suggests that property that was purchased with the intent of using it in the taxpayer's business produces business income when sold even if the property was never used in the business (and, indeed, even if the taxpayer never entered into the contemplated business). This seems wrong. If property was never used in a business and was always held for investment purposes, gain on its sale should be nonbusiness income even if the taxpayer may have contemplated using it in the business when it was first acquired.

Section IV.1.(a).(4)(C) provides that income from intangible property is business income when the intangible property serves an operational "as opposed to solely an investment" function. I would recommend that the word "solely" be deleted. It is not compelled by the Supreme Court's reference to operational functions in Allied-Signal. If property is held 98% for investment purposes and 2% for operational purposes, its sale should produce nonbusiness income. This is a further manifestation of what in my view is an inappropriately strong tilt toward business income classification.

The regulations might give some examples of when intangible property will produce business income. Possibilities include short-term securities held as working capital and stock of a supplier bought to assure a regular source of supply. Although the Supreme Court has suggested in Arkansas Best that in the latter situation the stock would nevertheless be a capital asset producing capital gain or loss on its sale, I see no reason why such a classification for federal income tax purposes should preclude its being treated as a business asset for state and local tax purposes.

I am somewhat troubled by the example in VI. The fact that property or its income may in the future be used in the business does not mean that the income should be treated as business income currently. Obviously, any investment income may some day be invested in the business as may the assets that produce it.

I would be pleased to discuss these matters with you or members of your staff at your convenience.

Best regards.

Sincerely,

Peter L. Faber

PLF:blh